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In the Matter of	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers	)	

REPLY COMMENTS OF
MFS COMMUNICATIONS COMPANY, INC.

MFS Communications Company, Inc. ("MFS"), by its undersigned counsel, hereby submits its reply comments upon the Notice of Proposed Rulemaking (the *"Notice"*), FCC 94-10, released in this docket on February 16, 1994.

Introduction

As stated in its initial comments, MFS supports the continued use of price cap regulation as a means of assuring that local exchange carriers ("LECs") charge just and reasonable and nondiscriminatory rates for their interstate services. At the same time, MFS believes that the existing price cap plan requires modifications to carry out more effectively the goal of preventing unreasonable discrimination and preferences in LEC rates. MFS showed in its comments that this goal is particularly crucial now, as the local exchange markets are in the early stages of transition from monopoly to competitive market structures. During this transition, there will be a greater risk of cross-subsidization and other anti-competitive behavior by the LECs than would exist in either pure monopoly or fully competitive markets, and continued regulatory vigilance is therefore required to assure that the public has an opportunity to receive the benefits that will result from the full development of effective telecommunications competition.

As was anticipated in the initial comments by MFS and many other parties, the LECs have proposed a diametrically opposite approach—they urge the Commission to reduce substantially the regulation of LEC rate structures based on the contention that widespread competition already exists in their markets. These reply comments will demonstrate that the LEC argument for greater pricing flexibility (as expressed primarily in the Comments of the United States Telephone Association ("USTA") and supported by the separate comments of many USTA member companies) is factually inaccurate and is contrary to the Commission's policies of preventing unreasonable discrimination and avoiding interference with the development of effective local competition.

I. Competition Is in the Early Stages of Development, and Is Not Sufficient to Justify Increased LEC Pricing Flexibility at This Time - Transition Issues 1a, 1b, 1c, 1d

The LECs' arguments for increased pricing flexibility are based substantially on their claims that they face widespread and increasing competition, and that under these conditions many existing Commission restrictions on changes in rate structures and levels are both unnecessary and contrary to the goal of a competitive market. *See, e.g.,* USTA at 34-40, 40-44. The underlying factual premise, however, is both inaccurate, because competition is far less substantial than the LECs try to make it seem, and incomplete, because it ignores the fact that LEC market power derives not merely from their market *share* but also from their control of bottleneck facilities and resources.

The extent of competition today in local exchange markets was discussed in MFS' initial comments at 37-39, and in the Comments of the Association for Local Telecommunications Services ("ALTS") at 12-16. As shown there, and by many other parties, LECs face competition only in relatively specialized niche segments of their markets. Although the potential exists for broader competition to develop in the future, particularly if efforts to open LEC bottleneck resources to competitors continue, no LEC yet faces any significant competition for the large share of revenues produced by basic local exchange service.

The LECs seek to reach a different conclusion by relying on potential as well as actual competition to demonstrate their lack of market power. *See* USTA at 37-40. In fact, the potential for meaningful and effective local telephony competition by wireless providers and cable television operators is extremely uncertain. *See* ALTS at 26-29. Moreover, *potential* competition would be relevant to an analysis of market structure only if the barriers to entry in local telephone markets were relatively low (so that a potential entrant could quickly be converted into a real competitor if the LEC sought to abuse its market power). As demonstrated in MFS' initial comments at 40-43, and 50-53, that is not at all the case. Numerous barriers—legal, technical, and practical—must be overcome before effective local telephone competition can become a reality.

In addition, the LECs try to make competition seem more widespread than it really is by limiting their market analysis to interstate access services, rather than considering the full extent of competition faced by their integrated networks. As MFS noted in its initial comments at 38 and 40 n.62, interstate access services only account for about one-quarter of LEC revenues and these services are provided over the same facilities and the same network that provides basic local exchange service and other intrastate telecommunications services. The potential for abuse of market power through cross-subsidization or unreasonably discriminatory rates is greatest when competitors serve only a narrow segment of the market and can thereby be easily targeted. If all sectors of the LEC market faced competition, such abuses would be much more difficult to commit. The relevant market analysis, therefore, must consider the extent of competition in *all* markets served by LECs.

MFS (as well as other parties) supplied relevant information regarding LEC market shares in its initial comments. As shown there, the total revenues of all competitive access providers today equal less than one percent of total LEC revenues.[1]

Moreover, as mentioned above, market share is not the only relevant fact to consider. The LECs can exclude or impede other companies, regardless of their relative size or financial strength, from entering their basic local exchange markets through a variety of tactics. These include outright legal prohibitions on local competition that remain in effect in the majority of states; legal handicaps on competitive entrants such as discriminatory taxes or franchise fees or restricted access to public rights-of-ways in some jurisdictions; control of physical facilities such as poles, conduits, building entrances, and "telephone closets" and riser cables inside multi-tenant buildings; and control of intangible resources such as telephone number assignments, databases, signalling information, and other service platforms that must be available on a non-discriminatory basis to all local service providers if effective competition is to exist.

USTA's analysis of competition fails entirely to consider these barriers to entry or to recognize that their removal is a necessary precondition to LEC pricing flexibility. On the other hand, at least some USTA members, including Ameritech, NYNEX, and Rochester Telephone, have recognized in principle (and to varying degrees) that any major relaxation of LEC regulation must be linked with removal of barriers to entry. The MFS transition proposal (as discussed in more detail in the following section) recognizes this linkage, and would reward those LECs that have made the greatest strides in removing obstacles to competition by permitting them to be the first to receive significantly expanded pricing flexibility.

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[1] Given this fact, USTA's speculation that CAP revenues may "more than triple by 1996" is hardly evidence of a substantial threat to the LECs. USTA at 35. Even if this comes to pass, it will simply mean a reduction in LEC market share from over 99 percent to around 97 percent.

For these reasons, the Commission should reject as unfounded the LECs' claims that competition is already sufficiently developed to justify substantial added pricing flexibility. Instead, as described in the following section, the Commission should adopt a transition plan that sets specific market entry goals that must be achieved before the LECs may qualify for pricing flexibility.

II. USTA's Pricing Flexibility Proposal Should Be Rejected in its Current Form - Baseline Issues 8a, 8b, 8c, 9a, 9b; Transition Issues 1b, 1c, 2, 3

The highlight of USTA's comments in this case, generally supported by its individual member companies, is a price cap "reform" proposal that is virtually identical to the proposals it previously submitted in its Petition for Rulemaking in RM-8356. MFS has previously addressed this proposal in its comments in RM-8356, filed Nov. 1, 1993, and incorporates that filing herein by reference to avoid repetition.

It may be useful to contrast USTA's proposal with MFS' transition proposal as contained in its initial comments. There are, in fact, a number of similarities between the two proposals, but also several significant differences that highlight the flaws in USTA's approach.

First, USTA proposes that "the degree of pricing flexibility afforded a LEC would increase as a market area is reclassified . . . based on the level of effective competition with the area." USTA at 58. MFS agrees with this approach in concept: the extent of pricing flexibility allowed to a LEC should depend on the extent to which that LEC faces *effective* competition.

Second, USTA proposes to implement pricing flexibility on a wire center by wire center basis. It reasons that "[a] LEC wire center is the smallest possible geographic area to which a competitive market analysis can be applied. Reliance on wire centers is appropriate because it minimizes the possibility of unreasonable price discrimination against customers without competitive alternatives." USTA at 59 (footnote omitted). However, the fact that the wire center is the *smallest* possible area to which a market analysis can be applied does not make it the appropriate one. As MFS showed in its initial comments, many LEC services are provided over joint and common facilities that serve multiple wire centers—for example, the interoffice transport and signalling networks, tandem switching facilities, and centralized billing systems. *See* MFS at 38 n.59. USTA concedes in a footnote that the presence of such facilities may require that market analysis be applied to larger geographic areas:

> A grouping of wire centers may also be appropriate for a competitive market analysis. For services that are not geographically-based (*e.g.*, services provided through a regional database), it may be appropriate to use a larger geographic area for competitive market analysis.

USTA at 59 n.154. Since most LEC services (especially switched access service) have at least some significant components that are not geographically-based, and because most barriers to competitive entry are under the regulatory jurisdiction of state agencies and therefore are best addressed on a state-by-state basis, MFS submits that its proposal to use study areas as the basic unit of analysis is superior to USTA's wire center approach.

Third, USTA proposes that the degree of LEC market power within a geographic area should be determined based upon "the proportion of access demand that is 'addressable' by alternative providers." USTA at 62. USTA contends that this approach is superior to approaches based on market share, supply capacity, or "contestability." *Id.* at 59-63. MFS agrees that supply capacity and contestability are inappropriate standards, and, as discussed in Section I, above, believes that market share is a useful indicator of market power but is not the only relevant criterion. MFS also agrees with the general concept of addressability as presented by USTA. "In effect, this indicator asks: Does the customer have real alternatives available?"

USTA at 62. That is quite clearly the correct question, although USTA's approach to answering it (as discussed in the following paragraphs) is inappropriate.[2]

USTA's proposed measure of "addressability" is inadequate because it ignores the 75% of the local exchange market that is jurisdictionally intrastate, and because it ignores the effects of barriers to entry. As discussed in Section I, above, the LECs' market power derives in large part from their monopoly over basic local exchange service and their ability to recover their joint and common costs over the full range of local services. The mere availability from competitors of selected interstate access services, which is all that USTA proposes to consider, would shed little if any light on the true degree of LEC market power within a geographic area. The MFS proposal would call for a more relevant, two-step analysis: first, the barriers to competitive entry in all forms of telecommunications service within a geographic area would have to be removed, and second, an opportunity for competitive services to become actually available within that geographic area would have to occur.

USTA's specific proposed "triggers" for pricing flexibility make a mockery of its proposed "addressability" standard. In practice, USTA's proposal would have little to do with LEC market power, and appears designed simply to provide LECs with the maximum ability to exercise pricing flexibility while they still have market power to exploit. Under USTA's proposal, a wire center could be classified as a Transitional Market Area (TMA) if *any* non-LEC access services were available to any customer within the area. USTA at 64-65. Since, among many other things, USTA suggests that this standard could be met by "the offering of a substitutable access service by a . . . cellular or PCS provider . . . [or] microwave carrier," *id.*, it is clear that virtually any wire center in the country could be classified as a TMA. Cellular

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[2] Because MFS' proposal relies upon state regulators to determine the state of competition within their jurisdictions, there would be no need for the Commission to adopt USTA's proposal to impose an additional set of reporting requirements upon competitive entrants. USTA at 64.

services are widely available in most parts of the United States. Indeed, VSAT (satellite-based) access networks, which USTA cites (at 39 n.103) as a form of local competition, are in principle "available" anywhere within a satellite's coverage area. Under USTA's proposal, any LEC could classify any wire center as a TMA simply by showing that it is within the footprint of a satellite and that VSAT services are "available" to customers in that area; it would not be necessary to show that any VSAT customers are actually present in the area. This "standard" clearly is no standard at all.

USTA's proposed test for designating a wire center as a Competitive Market Area (CMA) is equally lax. A LEC would have to show that either all access services or selected categories of services (USTA at 66 n.172) are "available" to customers representing either 25 percent of the LEC's interstate access demand or 20 percent of the total market for interstate access services; and that competitive services or facilities are actually being used or competitive bids are being solicited by customers representing 25 percent of the LEC's interstate access demand *or a single customer accounting for at least 15 percent of that demand.* USTA at 65. By limiting the scope of its proposal to interstate access services, for which demand is highly concentrated, USTA once again guarantees that any LEC can meet the test in any wire center. The three large interexchange carriers account for the great bulk of the demand, and one customer alone can easily satisfy both the 15% and 25% criteria in practically any wire center.[3] Thus, the proposed CMA criteria would automatically be satisfied for any wire center as soon

[3] In 1992, AT&T's total access expenses were $13.7 billion; the total carrier access revenues (state and interstate) of all reporting LECs were $20.4 billion. *Statistics of Common Carriers*, 1992/93 ed., pp. 29, 39. Thus, AT&T on average consumes about 65 percent of all LEC access services. Although this percentage may vary from one wire center to another, it would be an extremely rare case in which AT&T's share of demand was less than 25 percent. If that rare case actually exists, it is almost certainly because another single customer has an extremely large volume of demand in a particular location.

as the largest access customer in that area announced that it was soliciting bids for competitive access services.

In short, USTA's proposal is simply a prescription for deregulation of the LECs without doing anything to remove the market entry barriers that are the reason for regulation. MFS respectfully submits that the USTA approach should be rejected in favor of the plan presented in MFS' initial comments.

III. MFS Supports Elimination of the Vestiges of Rate of Return Regulation (Sharing and Low-End Adjustments) from the Price Cap Plan - Baseline Issue 4b

MFS does agree with one part of USTA's proposal—the elimination of earnings sharing and low-end adjustments from the price cap plan. USTA at 45-52. These two elements of the plan impose rate of return constraints on price cap LECs, thereby diluting the incentives for efficiency that are supposed to result from price cap regulation.

The retention of earnings regulation under price caps can create perverse incentives for anticompetitive behavior. A LEC that is successful under price cap regulation and knows it will have to share excess earnings with its ratepayers may have an incentive to reduce its revenues through selective (and perhaps predatory) price cuts in targeted market segments in order to preserve its market share in these segments. The LEC may well decide that it can improve its competitive position more by voluntarily "sharing" its excess earnings on a targeted basis with a relatively few preferred customers than by reducing rates across the board through mandated sharing. Conversely, a LEC that is suffering from low earnings may conclude that it has nothing to lose by engaging in targeted (and perhaps predatory) price reductions in selected market segments, since the resulting loss of revenue can be shifted to captive customers the following year through an upward adjustment in the price cap.

It is well-known that rate of return regulation creates incentives for inefficiency and encourages cross-subsidization and other forms of anti-competitive behavior. Although price cap regulation is not a perfect solution to the problem, it does moderate these incentives and provides some offsetting incentives to encourage efficiency. The existence of a rate of return "overlay" on price caps, which restricts LEC earnings to a relatively narrow range through low-end adjustments and sharing, reduces the potential benefits of price caps and preserves some of the worst features of rate of return regulation. Accordingly, MFS supports USTA's proposal for elimination of earnings regulation.

Conclusion

For the foregoing reasons, USTA's proposed changes to the price cap plan should be rejected, except for the elimination of earnings sharing and low-end adjustments, and the plan presented in MFS' initial comments should be approved.

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CERTIFICATE OF SERVICE

I hereby certify that on this 29th day of June, copies of the foregoing REPLY COMMENTS OF MFS COMMUNICATIONS COMPANY, INC., have been sent via hand-delivery to the persons on the attached service list.

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